Chief Executive's Statement

2012 was an eventful year both in the financial and political contexts. Major elections and changes in governments occurred in different parts of the world. The inconclusive Greek elections in May rekindled concerns not only over the possibility of Greece exiting the euro area, but a collapse of the Eurosystem. As the situation in Europe worsened with market sentiment shrinking, the European Central Bank (ECB) President Mario Draghi said in July that "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." In September, the ECB announced the framework of an unprecedented Outright Monetary Transactions programme, which succeeded in easing the concerns on the tail risk of the euro falling apart, thereby arresting further deterioration in market sentiment. In the same month, the US Federal Open Market Committee (FOMC) announced the third round of quantitative easing, followed by the launch in January 2013 of a further expansion of the scale to US$85 billion a month, without a time limit, until the employment situation in the US substantially improves. In Japan, the newly elected Government announced its plans in November to revitalise the Japanese economy through, amongst other measures, more aggressive quantitative easing by the Bank of Japan.

These developments helped calm global financial markets, resulting in an improvement in market sentiment. With the pick up in investors' risk appetite and with an even larger amount of surplus funds searching for yields, we started to see a revival in the flow of funds into the Hong Kong dollar in the final quarter of 2012. The total amount of inflows through the Currency Board Account was over HK$100 billion, which was smaller in scale than the last wave of inflows of over HK$640 billion registered between the last quarter of 2008 and the end of 2009. The smooth operation of the strong-side Convertibility Undertaking helped demonstrate to the public the Government's commitment and ability to maintain the Link, which is the cornerstone of monetary and financial stability in Hong Kong. Indeed, the International Monetary Fund reaffirmed its strong endorsement of the Link in its annual Article IV Consultation in November stating it remained the most appropriate regime for Hong Kong as a small and open economy.

Given the exceptionally low interest rates in the US and in Hong Kong and the abundance of surplus liquidity globally, overheating of the property market remained the biggest risk to banking and financial stability in Hong Kong. As soon as the FOMC announced its third round of quantitative easing in September, the HKMA launched the fifth round of countercyclical prudential measures to further enhance the risk management and resilience of the banking system. This was followed in October by additional tax measures introduced by the Hong Kong Special Administrative Region Government which together helped reduce the exuberance of the property market for a while. But, as we know, overheating in both the residential and commercial property sectors resumed in January 2013. Nevertheless, the HKMA succeeded in holding back the trend of sharp increases in the growth of general credit in the banking system in 2012, which moderated to a more sustainable level of around 10%, compared with 20% in 2011 and 29% in 2010.

We also enacted new legislation that enabled the HKMA to implement the new capital rules promulgated by the Basel Committee on Banking Supervision, which form the international minimum standards for banks. In June, the HKMA, in collaboration with the Securities and Futures Commission, announced a package of measures to promote and facilitate further development of private banking in Hong Kong. It includes the option to switch from a transaction-by-transaction basis to a portfolio-based approach in ensuring suitability of investment recommendations. The HKMA also encouraged the industry to set up a new private wealth management association to promote industry-wide standards, a code of ethics and an enhanced competency framework for practitioners. Separately, the HKMA continued with its programme to reach out to overseas asset owners and managers to promote Hong Kong as an asset management hub in Asia. These outreaching efforts were favourably received and are producing positive results for Hong Kong.

With the support of the Central People's Government and the ministries concerned, Hong Kong continued to develop and consolidate its position as the global hub for offshore renminbi businesses. As compared with the previous year, the amount of renminbi trade settlement handled by banks in Hong Kong increased by 37% to RMB2.63 trillion, and renminbi bank loans grew 1.6 times to RMB79 billion. The dim sum bond market remained buoyant with a total issuance of RMB112 billion; and with a deposit pool of over RMB700 billion, Hong Kong remained the biggest and most liquid offshore renminbi centre in the world. During the year, the HKMA launched several initiatives to develop Hong Kong as the most open and user-friendly offshore renminbi platform not only for customers based here, but for overseas corporates and banks as well. These included extending the operating hours of the renminbi interbank payment system (renminbi RTGS system) to 15 hours, from 8:30 a.m. to 11:30 p.m. Hong Kong time, enabling customers in the European time zone and early North American business

hours to make or receive real-time renminbi payments. At the same time, the HKMA played a leading role in roadshows overseas to promote Hong Kong's renminbi platform, and worked in partnership with the UK Treasury, the Australian Treasury and the Reserve Bank of Australia respectively to set up co-operative forums to help promote the use of Hong Kong in developing offshore renminbi businesses in London and Sydney respectively. As an illustration of the global network that Hong Kong is currently serving, over 1,400 renminbi correspondent bank accounts were opened by overseas banks in Hong Kong and over 200 banks, including some that do not have operations in Hong Kong, have joined our renminbi RTGS system. The average daily turnover jumped significantly from RMB5 billion in 2010 to RMB121 billion in 2011 and further to RMB264 billion in December 2012. It is important to note that, of these payments, only 10% were cross-border flows into or out of the Mainland while the rest were payments to and from offshore entities. This is clear evidence of the rapid development of offshore economic and financial activities involving payments in renminbi.

Benefiting mainly from the improvement in the market sentiment and liquidity driven equity markets globally, the investment income of the Exchange Fund was HK$111.6 billion, the second highest amount in the history of the Fund. The Backing Portfolio, which can only hold highly liquid top quality short-term US papers, achieved a low return of 0.4%. However, the Investment Portfolio achieved a return of 8%, pushing up the overall rate of return for the entire Exchange Fund to 4.4%. I am also pleased to report we have made good progress in diversifying the investments of the Exchange Fund into a Long-Term Growth Portfolio (LTGP) comprising emerging market bonds and equities, renminbi assets, private equity and real estate. At the end of 2012, the value of the invested assets, together with the commitment awaiting draw-downs, was around HK$200 billion. The rate of return of the LTGP since its inception has so far been satisfactory with emerging market bonds and equities, and renminbi assets achieving an annualised rate of return of 8%, and private equity and real estate achieving an annualised internal rate of return of 10%. Towards the end of last year, the HKMA conducted a review of the LTGP investments and the Financial Secretary, on the advice of EFAC, decided to re-group the emerging market bonds and equities, and renminbi assets in the Investment Portfolio, thereby creating further headroom for the LTGP to develop in the years ahead.

Although we entered 2013 with significantly improved market sentiment and investors' risk appetite, there is no room for complacency. Most of the fundamental causes leading to the global imbalances have not been fully addressed while many structural reforms that are needed to bring back fiscal discipline and competitiveness in the advanced economies remain to be implemented. The larger the scale of the quantitative easing environment and the longer the exceptionally low interest rate lasts, the greater will be the uncertainty and risks of the eventual exit. Therefore, we must remain vigilant to developments in the global financial and economic systems and at the same time guard against and, more importantly, stand ready to cope with possible shocks that may hit Hong Kong in the months ahead.

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